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No. 01-397

IN THE
Supreme Court of the United States

SCHOLASTIC CORPORATION and RAYMOND MARCHUK,

Petitioners,

v.

RICHARD TRUNCELLITO and THE CITY OF PHILADELPHIA,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF PETITIONERS AND BRIEF *AMICUS CURIAE*

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF PETITIONER

The American Institute of Certified Public Accountants (the "Institute") hereby respectfully moves for leave to file the attached brief as *amicus curiae* in this case. The consent of the attorney for Petitioners has been obtained. The consent of the attorney for Respondents was requested but refused. The issue presented in this case — the proper pleading standard for scienter under the Private Securities Litigation Reform Act of 1995 (the "Reform Act") — is one of vital interest to the Institute. The Institute is the national organization of the certified public accounting profession. Among other things, it develops authoritative accounting, auditing and ethical standards which, in conjunction with SEC rules, govern independent auditors in reporting on a company's financial statements in publicly filed documents.

In enacting the Reform Act, Congress intended to create uniformity and stringency in the pleading of securities fraud claims, to, among other things, curb strike suits that targeted "deep pocket" defendants such as accountants and other professionals. Since the passage of the Reform Act, however, the circuit courts of appeal have differed drastically in their interpretations of its requirements. Most striking among the circuits' various standards is that applied by the Second Circuit in the present case. Significantly, rather than requiring a plaintiff to plead contemporaneous particularized facts giving rise to a strong inference of knowledge or, at the very least, severely reckless disregard, as required by the Reform Act, the Second Circuit accepted allegations of facts merely indicating what the defendants "should have known" — essentially, "fraud by hindsight" pleading — as well as allegations of "motive and opportunity" alone to establish intent. The brief that the Institute

seeks leave to file as *amicus curiae* joins Petitioners' argument supporting a grant of *certiorari* in this case, but also addresses more broadly the far-reaching implications that the Second Circuit's ruling may have on accountants and other professionals if allowed to stand. As discussed in the attached brief, the less demanding Second Circuit standard renders outside auditors and accountants, whom Congress specifically intended to protect through the passage of the Reform Act, especially vulnerable to securities fraud claims. Because of the nature of the audit process and the client-auditor relationship, plaintiffs can readily claim that an auditor "should have known" about the alleged financial fraud, if there is no requirement that a plaintiff set forth particularized facts regarding the auditor's state of mind.

The conflict among the circuits regarding the Reform Act's pleading requirements has only become more apparent since Petitioners filed their Petition for Writ of Certiorari on August 30, 2001. In the last two months, the Fifth, Eighth and Tenth Circuits have issued opinions interpreting the Reform Act in a manner that is in conflict with the Second Circuit's approach. We believe the need for this Court's resolution of the issue has thus reached a critical juncture. Accordingly, the Institute respectfully requests that this Court grant *certiorari* to the Second Circuit and hear this case.

Respectfully submitted,

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QUESTIONS PRESENTED

I. Is the Second Circuit's pleading standard for securities fraud lawsuits, permitting plaintiffs to allege securities fraud without pleading either (i) particularized facts specifying how each statement was misleading or (ii) particularized facts giving rise to a strong inference of scienter, inconsistent with the plain language of the statute?

II. Is the Second Circuit's decision inconsistent with the plain language of the statute because it holds, in direct conflict with other courts of appeals, that:

A. A complaint may survive dismissal based solely on inferences that are "not unreasonable," rather than on "strong inferences";

B. A complaint may survive dismissal even though allegations made on information and belief do not include "all facts" on which the belief is formed; and

C. A complaint may survive dismissal where scienter is alleged solely by pleading that a defendant had "motive and opportunity" to commit fraud.

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PRELIMINARY STATEMENT*

The American Institute of Certified Public Accountants (the "Institute") respectfully submits this brief as *amicus curiae*, pursuant to Rule 37.2 of the Rules of the United States Supreme Court, in support of Petitioners Scholastic Corporation and Raymond Marchuk.

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE* AND SUMMARY OF ARGUMENT

The Institute is the national organization of the certified public accounting profession, with more than 330,000 members. Among the Institute's principal purposes are the promotion and maintenance of the highest professional standards of practice. The Institute develops authoritative accounting, auditing, and ethical standards, including ones which, in conjunction with SEC rules, govern independent auditors in reporting on a company's financial statements in publicly filed disclosure documents.

The Institute and its members are vitally interested in this case, which involves a conflict among the circuits not yet addressed by this Court: the proper pleading standard under the Private Securities Litigation Reform Act of 1995 (the "Reform Act"). The Institute has a long-standing interest in the scope and bases of civil liability sought to be imposed on accountants under the federal securities laws. The Institute's predecessor, the American Institute of Accountants, participated in the legislative efforts leading to the Securities Exchange Act of 1934.

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* The American Institute of Certified Public Accountants states that no counsel, other than counsel of record herein, has written this brief, and that no person or entity, other that the *amicus* has made a monetary contribution to the preparation or submission of this brief.

The Institute has continued to participate in legislative efforts involving the federal securities laws, and supported the passage of the Reform Act. The Institute has also participated as *amicus curiae* in numerous cases before the federal courts addressing liability under the judicially implied Section 10(b) private right of action.

In enacting the Reform Act, Congress found specifically that accountants and other perceived "deep pocket" defendants were common targets of "abusive and manipulative" securities litigation "without regard to their actual culpability." Joint Explanatory Statement of the Committee of Conference, Statement of Managers, H.R. Conf. Rep. No. 104-369, at 31-32 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31 ("Conf. Rep."). Plaintiffs in such litigations would claim that fraudulent behavior "must" have occurred because of a restatement or drop in stock price, and the lower courts analyzed defendants' intent under varying standards of "recklessness." As a consequence, class action plaintiffs were able to ensnare accountants in costly, vexatious litigation merely by alleging that they had acted "recklessly" in conducting an audit of a publicly traded company whose stock price had fallen.

The Reform Act was passed to address such abuses. Congress chose, as a principal means of reform, to establish "uniform" and "more stringent" pleading requirements for private securities actions. Conf. Rep. at 41.[1] Thus, Congress

[1] *See also* Hearing on Private Securities Litigation Reform Act of 1995 Before the Senate Subcomm. on Securities of the Comm. on Banking, Housing & Urban Affairs, 105th Cong., 1st Sess. (July 24, 1997) (statement of Richard I. Miller, General Counsel, the Institute) (Reform Act imposes "[a] number of important provisions designed to realign the incentives of the securities litigation system . . . including a heightened pleading standard to filter out boilerplate complaints [and] a safe harbor for forward-looking statements intended to increase disclosure of company information to investors.").

formulated statutory language that was based "in part on the pleading standard of the Second Circuit," the "most stringent pleading standard" at the time, expressly stating, however, that its intent was not to codify that standard, but in fact to "strengthen" it. *See* Conf. Rep. at 41 & n.23.

Far from establishing a uniform and more stringent pleading standard, however, there has been only debate and confusion among federal courts. Most conspicuous among the conflicting scienter pleading standards is that of the Second Circuit, which not only is at odds with the majority of other circuits' interpretation of the Reform Act, but also is in conflict with the plain language of the statute itself. Significantly, the Second Circuit in the present case allowed a complaint to survive dismissal with allegations that established, at most, a *reasonable* inference that the defendant *should have known* about the alleged fraud, rather than a *strong* inference that the defendant *knew or must have known*, as the Reform Act requires.

The conflict among the circuits has become more apparent since the filing of the Petition; in the past two months, the Fifth, Eighth and Tenth Circuits have issued opinions that are inconsistent with the Second Circuit's standard. *See Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, Nos. 99-3536, 99-3586, 99-3587, 2001 WL 1334728 (8th Cir. Oct. 25, 2001); *Nathenson v. Zonagen, Inc.*, No. 99-20449, 2001 WL 1131511 (5th Cir. Sept. 25, 2001); *City of Philadelphia v. Fleming Cos.*, No. 00-6081, 2001 WL 1024039 (10th Cir. Sept. 7, 2001). Without resolution by the Supreme Court of the proper pleading standard under the Reform Act, Congress' intent will remain unreflected, and accountants and others will continue to be exposed to the very risks of abusive Section 10(b) litigation that Congress intended to remedy.

ARGUMENT

I. Congress Intended The Reform Act To Remedy The Rampant Abuse And Manipulation Of Securities Class Actions That It Found Under The Lower Courts' Pleading Standards.

Congress was "prompted by significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets." Conf. Rep. at 31. Congress found that the pleading requirements adopted by the lower courts had permitted "the routine filing of lawsuits . . . whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action." *Id.* Once filed, these strike suits led to "abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle." *Id.* In the end, Congress found, only the plaintiffs' lawyers benefited without regard to any meaningful recovery by supposedly "injured" investors. *Id.*

Congress also found that these lawsuits especially injured accountants, underwriters, and other third parties. The House and Senate committees heard significant evidence that the class action bar routinely targeted accountants and other perceived "deep pocket defendants" in Section 10(b) class actions "without regard to their actual culpability." Conf. Rep. at 31. This was facilitated by, among other things, the varying standards that courts adopted for alleging recklessness as a theory of scienter under Section 10(b). Under lax pleading standards, even garden variety negligence claims could be brought as Section 10(b) claims simply by pointing to a

restatement and asserting that an accountant had acted "recklessly" in conducting an audit of the issuing company — essentially alleging "fraud by hindsight." "In these and other examples of abusive and manipulative securities litigation," Congress found, "innocent parties are often forced to pay exorbitant 'settlements.' " *Id.* at 32. This abusive litigation resulted in adverse "ripple effects" on the accounting industry, impeding the provision of professional services to market participants, reducing the level and quality of financial reporting, and ultimately injuring the investing public. *Id.*; *see also Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 189 (1994).

II. Rather Than Establishing A Uniform And More Stringent Pleading Standard For Federal Private Securities Actions, The Reform Act Has Had The Opposite Result.

Congress determined that the principal means to achieve reform in private federal securities actions was to strengthen the existing pleading standards. As explained in the Conference Committee Report on the Reform Act, Congress decided to establish "uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits." Conf. Rep. at 41.[2] The Conference Committee thus adopted a heightened standard for pleading fraud, which required securities plaintiffs to -

> specify each statement alleged to have been misleading, the reason or reasons why the

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[2] The Conference Committee Report is the "authoritative source for [determining] legislative intent." *Thornburg v. Gingles*, 478 U.S. 30, 44 n.7 (1986).

> statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1). The Reform Act also imposed a heightened standard for pleading intent, requiring that, with respect to each alleged act or omission, the complaint "state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added).

Before the passage of the Reform Act, the Second Circuit's pleading standard was seen as the most rigorous among the circuits' various standards. Conf. Rep. at 41 ("Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a 'strong inference' of the defendant's fraudulent intent."). It provided that scienter could be established with facts (i) demonstrating that defendants had the "motive and opportunity" to commit the fraud, or (ii) otherwise showing "strong circumstantial evidence of conscious misbehavior or recklessness." *See, e.g., Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994). Congress stated that while the language of the Reform Act was "based in part" on the stringent Second Circuit standard, it deliberately omitted from the statute the Second Circuit's language regarding "motive," "opportunity" and "recklessness," stating that its intent was to "strengthen" the pleading standard. *Id.*

The circuit courts of appeal, however, have debated repeatedly whether Congress intended the Reform Act to

codify the Second Circuit's standard for pleading scienter. *See Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 620 (4th Cir. 1999) ("[A]lthough the new statute indisputably seeks to make pleading scienter more difficult for plaintiffs, there is 'widespread disagreement among courts as to the proper interpretation of the PSLRA's heightened pleading requirement.' ") (citations omitted). As a result, courts have adopted varying standards for pleading scienter, differing in their views on what factual allegations will satisfy the "strong inference" requirement, permitting "recklessness" and interpreting it widely, and disagreeing on whether and to what extent "motive and opportunity" allegations should be a viable substitute for intent. In short, Congress' effort to bring uniformity to the pleading of Section 10(b) claims has resulted in anything but.

III. The Second Circuit's Standard Is Both The Least Stringent Among The Standards Articulated By The Various Circuits And The Most Inconsistent With The Plain Language Of The Reform Act And Congress' Intent.

In stark contrast to the Reform Act's requirement that a plaintiff plead contemporaneous particularized facts indicating a strong inference of defendant's intent, the Second Circuit in *Scholastic* allowed allegations of events that took place *after* the alleged fraud to establish that the defendant "should have known" about the fraud at the time it occurred. That is, the court, at best, permitted "fraud by hindsight" pleading, and, at worst, adopted essentially a negligence standard. The Second Circuit in *Scholastic* also allowed allegations of "motive and opportunity" alone to establish scienter, going against both the majority of circuits to have decided the issue and Congress' intent in enacting the Reform Act.

A. The Second Circuit Permits Allegations Demonstrating That A Defendant "Should Have Known" About The Fraud, Rather Than "Knew Or Must Have Known."

The Reform Act requires a plaintiff to allege with particularity facts that give rise to a strong inference that the defendant acted with the "required state of mind." 15 U.S.C. § 78u-4(b)(2). In the case of an alleged violation of Section 10(b), the "required state of mind" must be gleaned from the statutory language, which expressly requires "manipulative or deceptive" conduct. 15 U.S.C. § 78j(b). As this Court stated in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) ("*Hochfelder*"), this language proscribes only "knowing or intentional misconduct." *Id.* at 197. This Court expressly declined to adopt a subjective recklessness standard in *Hochfelder*, although it observed that under limited circumstances recklessness was viewed in "certain areas" of the law as a form of intentional conduct. *Id.* at 193-94 n.12. After this Court's decision in *Hochfelder*, but before the passage of the Reform Act, many of the circuit courts held that allegations of recklessness sufficed to meet the scienter requirement of Section 10(b), defining reckless conduct as the Seventh Circuit did in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977):

> [R]eckless conduct [is] a highly unreasonable omission, involving . . . an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that it is either *known to the defendant or* is so obvious that *the actor must have been aware of it.*

Id. at 1045 (emphasis added) (citation omitted). *See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990);

McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989); *Broad v. Rockwell*, 642 F.2d 929, 961-62 (5th Cir. 1981); *Mansbach v. Prescott, Ball & Turber*, 598 F.2d 1017, 1024 (6th Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978).

Courts today generally agree that a heightened recklessness of the type defined in *Sundstrand* continues to satisfy the intent requirement the Reform Act, although each circuit presents a different articulation of the precise level of recklessness that the statute requires. *See Greebel v. FTP Software, Inc.*, 194 F.3d 185, 199 (1st Cir. 1999) ("[R]ecklessness does not encompass ordinary negligence and is closer to a lesser form of intent."); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999) ("We quantify scienter as encompassing at least a showing of severe recklessness. . . ."); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 977 (9th Cir. 1999) ("[R]ecklessness only satisfies scienter under § 10(b) to the extent that it reflects some degree of intentional or conscious misconduct."); *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542, 550 (6th Cir. 1999) (recklessness is "a mental state apart from negligence and akin to conscious disregard").[3] More important than the differences in how courts characterize the proper level of recklessness, however, is the type of allegations they deem adequate to satisfy even a heightened recklessness standard. The Tenth Circuit recently held that

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[3] While the question of whether recklessness suffices to establish intent has not been raised by the parties in *Scholastic*, and is no longer heavily debated by the circuit courts of appeal, the Institute notes that this Court has not yet spoken on the issue, and submits that the legislative history of the Reform Act strongly suggests that Congress intended the required mental state for Section 10(b) claims to surpass recklessness.

in order to meet the *Sundstrand* definition of recklessness in a Section 10(b) claim, a plaintiff must allege the "defendant's knowledge [at the time of the fraud] of a fact that was so obviously material that the defendant *must* have been aware both of its materiality and that its non-disclosure would likely mislead investors." *City of Philadelphia v. Fleming Cos.*, No. 00-6081, 2001 WL 1024039, at *10 (10th Cir. Sept. 7, 2001) (emphasis added).

By contrast, the Second Circuit, while purporting to adopt the stringent recklessness definition in *Sundstrand* (*see Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir.), *cert. denied*, 531 U.S. 1012 (2000)), has demonstrated a tolerance for scienter allegations that essentially support mere negligence. That is, rather than requiring a plaintiff to allege with particularity facts giving rise to a *strong* inference that plaintiff *knew or must have known* about the fraud, it allowed a complaint to survive dismissal based on allegations that created a *reasonable* inference that a defendant *should have known*. Specifically, the Second Circuit in *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63 (2d Cir.), *petition for cert. filed*, 70 U.S.L.W. 3164 (U.S. Aug. 30, 2001) (No. 01-397), held that "post-class period data may be relevant to determining what a defendant knew or *should have known* during the class period." *Id.* at 73 (emphasis added). Additionally, the court permitted allegations of defendants' access to certain information during the class period to establish that they "*should have known* they were misrepresenting material facts with respect to the corporate business" at the time they allegedly had this access. *Id.* at 76 (emphasis added). The Second Circuit thus diluted the quality of pleadings required to establish a fraudulent state of mind, effectively lowering the level of scienter that must be pled under the Reform Act, to negligence.

B. The Second Circuit's Allowance Of "Motive and Opportunity" Alone To Establish Scienter Permits Section 10(b) Complaints To Survive Motions To Dismiss With Less Than A Strong Inference Of Scienter.

The Second Circuit's continued holding here, that a showing of "motive and opportunity" suffices to establish scienter, further demonstrates its acceptance of allegations that do not give rise to a strong inference of knowledge or, at least, severe recklessness. Prior to the passage of the Reform Act, several circuit courts of appeals had held that plaintiffs could allege through facts showing a defendant's "motive and opportunity" to commit securities fraud; that is, that defendants benefited in some concrete and personal way from the purported fraud, such as when the defendants made material misrepresentations to maintain a high stock price, while selling their own shares at a profit. *See generally Chill v. General Elec. Co.*, 101 F.3d 263, 267-68 (2d Cir. 1996).

Today, the circuits are divided on the question of whether plaintiffs may still use "motive and opportunity" pleadings to demonstrate scienter under the heightened pleading requirements of the Reform Act. Only the Second and Third Circuits have reaffirmed their pre-Reform Act position that evidence of motive and opportunity to commit securities fraud may still satisfy the scienter pleading requirements. *See Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 537-38 (2d Cir. 1999); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999).

Most other circuits that have decided the issue, however, have held that while motive and opportunity may be *relevant* as evidence that contributes to an overall showing of scienter,

they do not alone constitute a separate, alternative method of pleading scienter. *See City of Philadelphia*, 2001 WL 1024039, at *11; *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550-51 (6th Cir.), *petition for cert. filed* (U.S. Sept. 27, 2001) (No. 01-5138); *Greebel*, 194 F.3d at 197; *Bryant*, 187 F.3d at 1282-83. This conclusion supports the Reform Act's requirement that a plaintiff plead facts giving rise to a "strong inference" of scienter. *See Nathenson v. Zonagen, Inc.*, No. 99-20449, 2001 WL 1131511, at *8 (5th Cir. Sept. 25, 2000). Indeed, motive and opportunity are *not* the equivalent of a substantive scienter standard, and to allow such allegations to take the place of facts giving rise to a strong inference of recklessness or conscious misbehavior would "allow potentially frivolous lawsuits to go forward with only minimal allegations of scienter." *City of Philadelphia*, 2001 WL 1024039, at *12.

IV. The Less Stringent Pleading Standard Of The Second Circuit Renders Accountants and Auditors Especially Vulnerable To Frivolous Section 10(b) Claims.

As a result of its decision in *Scholastic*, the Second Circuit has, among other things, opened the door to fraud by hindsight pleading and allegations of fact that give rise to an inference essentially of negligence, as well as minimal "motive and opportunity pleading." As discussed below, this result holds particularly dire consequences for auditors and accountants, and essentially returns the jurisprudence to that which existed pre-Reform Act.

A. Allowing Allegations That A Defendant "Should Have Known" About The Fraud Will Only Encourage The Second-Guessing Of Auditors And The Audit Process That The Reform Act Sought To Avoid.

Allegations giving rise to a *reasonable* inference that a defendant "should have known" about a fraud can be especially harmful to outside auditors and accountants because of the nature of the audit process, which depends on estimates and the exercises of judgment:

> [A]n audit report is not a simple statement of verifiable fact that . . . can be easily checked against uniform standards of indisputable accuracy. . . . Although ultimately expressed in shorthand form, the report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage.

Bily v. Arthur Young & Co., 834 P.2d 745, 763 (Cal. 1992). Under the lesser pleading requirements articulated and applied by the Second Circuit in *Scholastic*, plaintiffs could avoid dismissal simply by alleging, in a restatement case, for example, that conspicuous warning signs "must" have existed that were available to the auditor during the audit, and thus, the auditor "should have known" about the accounting errors. *See In re SmarTalk Teleservs., Inc. Sec. Litig.*, 124 F. Supp. 2d 505, 516 (S.D. Ohio 2000) (rejecting as hindsight pleading plaintiffs' argument that the magnitude of the accounting error established that the auditors "should have known" of GAAP violations); *but see Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1256 (N.D. Ill. 1997) ("The more serious the error, the less believable are

defendants' protests that they were completely unaware of [the Company's] true financial status and the stronger is the inference that defendants must have known about the discrepancy.").

Indeed, the greater the restatement, the greater the likelihood that the complaint will survive a motion to dismiss, without regard to whether plaintiff alleged any specific facts indicating what the auditor actually knew or must have known at the time of the alleged fraud. *See Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1013 (S.D. Cal. 2000) ("Inferring scienter from the magnitude of [the] fraud invites a court to speculate as to the existence of specific (but unpled and unidentified) warning signs that show the accountant acted with scienter."); *but see In re Microstrategy, Inc. Sec. Litig.*, 115 F. Supp. 2d 620 (E.D. Va. 2000) (allegations regarding nature of restatement, *i.e.*, number, size, timing, frequency, and context, can raise strong inference of scienter).

Rather, to plead scienter in accordance with the Reform Act, a plaintiff should be required to identify "specific, highly suspicious facts and circumstances available to the auditor at the time of the audit" that "were deliberately ignored or must have been known." *In re SmarTalk Teleservs. Sec. Litig.*, 124 F. Supp. 2d at 514; *see also In re Ikon Office Solutions, Inc. Sec. Litig.*, 66 F. Supp. 2d 622, 629 (E.D. Pa. 1999) (plaintiff alleged that accountant's file contained handwritten note revealing that client's management had told him an employee was "cooking the books"); *In re Health Mgmt., Inc. Sec. Litig.*, 970 F. Supp. 192, 203 (E.D.N.Y. 1997) (plaintiff alleged that accountant possessed letter from analyst with specific warning that client had improperly inflated accounts receivable).

Accepting lesser allegations of what a defendant "should have known," as permitted by the Second Circuit, would also allow plaintiffs improperly to fault auditors for the conduct of their client. A plaintiff could merely allege, based on the closeness of the relationship with the company and access to information, the auditor "should have known" about the client's fraud. *See In re Reliance Sec. Litig.*, 135 F. Supp. 2d 480, 510 (D. Del. 2001) (genuine issue of fact existed as to what KPMG "knew or should have known" with regard to the accounting fraud, because of the information that was available to it); *Danis v. USN Communications, Inc.*, 73 F. Supp. 2d 923, 942 (N.D. Ill. 1999) (denying motion to dismiss; auditor was alleged to have had "sufficient contact" with company to "become aware of [its] fraudulent abuses and pervasive and fundamental internal control problems"); *but see Reiger*, 117 F. Supp. 2d at 1009 (nine-year relationship and familiarity was not enough to impute accountant with knowledge of every detail of client's business). This flies squarely in the face of Congress' intent in adopting a heightened pleading standard.

B. "Motive and Opportunity" Alone Cannot Be Enough To Establish An Outside Auditor's Intent To Defraud.

The inadequacy of motive and opportunity pleading alone as a basis for fraudulent intent is especially apparent in the case of independent auditors, for whom the standard should be largely inapplicable. As one court put it, auditors

> will rarely, if ever, have any rational economic incentive to participate in its client's fraud. . . . [A]n independent auditor has no ability to line its pockets through insider trading, and no incentive

> to cover up corporate mismanagement. The accountant's success depends on maintaining a reputation for honesty and integrity, requiring a plaintiff to overcome the irrational inference that the accountant would risk its professional reputation to participate in the fraud of a single client.

Reiger, 117 F. Supp. 2d at 1007. Indeed,

> in the absence of evidence that an outside accountant has become an insider in the subject company, e.g., by purchasing stock whose value is then inflated by the misstatements, it appears unlikely for any plaintiff ever to demonstrate sufficient motive to provide a strong inference pursuant to the motive and opportunity test that an outside accountant or accounting firm committed fraud.

Retsky Family Ltd. P'ship v. Price Waterhouse LLP, No. 97 C 7694, 1998 WL 774678, at *9 (N.D. Ill. Oct. 21, 1998).

Nevertheless, were motive and opportunity to remain as an alternative mode of pleading scienter, as permitted by the Second Circuit in the present case, creative plaintiffs would find ways to allege a "concrete benefit," other than a fee, that the auditor could obtain by maintaining its relationship with the client company — for example, the auditor's desire to maintain a competitive position vis-à-vis other accounting firms. *See In re Resource America Sec. Litig.*, No. Civ. 98-5446, 2000 WL 1053861, at *8 (E.D. Pa. July 26, 2000) ("[T]he motive alleged — that is, the desire to maintain its competitive position as to other accounting firms by retaining

three substantial and interrelated clients — gives rise to a strong inference of scienter."). There would be a high probability, however, that such litigation-induced "motives," standing alone, would be irrelevant to whether the auditor knew or must have known about the company's fraud.

V. The Issue Of The Pleading Requirements Under The Reform Act Is Ripe For Review By The Supreme Court.

Congress' intent in passing the Reform Act was absolutely clear — to put in place a significant statutory pleading hurdle for Section 10(b) actions that would curtail meritless claims, including particularly those brought against the accounting profession, and establish uniformity in pleading among the circuits. As discussed above, however, Congress' intent has in no way been achieved, as courts have interpreted and applied the pleading requirements of the Reform Act widely. The result is a lack of uniformity in the pleading standard from circuit to circuit, confusion in the application of those standards among the district courts, and a tendency, begun by the Second Circuit, to slip back to a pre-Reform Act era of pleading. Resolution by the Supreme Court is crucial to establish the uniformity and stringency that Congress intended. Accordingly, the Institute respectfully requests that a writ of certiorari be granted so that the Supreme Court may review the judgment of the Second Circuit.

CONCLUSION

For the foregoing reasons, the Institute respectfully submits that the Petition of Scholastic Corporation and Raymond Marchuk should be granted.

Respectfully submitted,

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